

NATIONAL FORECAST DESCRIPTION

The Forecast Period is the Second Quarter of 2001 through the Fourth Quarter of 2004

The U.S. economic outlook has changed noticeably compared to the July 2001 forecast. Most notably, the current forecast includes a recession in the second half of this year. This weakening reflects the combined impacts of the slowing that took place over the summer as well as the terrorists' attacks on America. After surprising resilience, the nation's unemployment rate jumped last August. With job markets weakening and the stock market in turmoil, consumer confidence slid precipitously this summer, threatening the consumer spending that has been the last component propping the economy in recent months. These factors may have taken the economy to the brink of a downturn, but it was the terrorists' attacks that pushed it into a recession in the third quarter of 2001.

This recession is expected to be mild by historical standards. Specifically, it is expected to last just two quarters (the minimum to be classified as a recession) and real GDP is anticipated to shrink about one-half percent. Although its duration is about the same as the 1990-91 recession (eight months), its depth is not nearly as severe. Real GDP declined 1.4% during the 1990-91 recession. The 2001 recession also compares favorably to the longer historical record. Business cycle data going back to 1920 show the average recession lasted 14 months and real GDP shrank 6.6%.

The 2001 recession should be relatively mild because of the stimulation factors already in the pipeline. Lower interest rates should have a significant role in returning the economy to growth. The Federal Reserve is currently in the midst of its most aggressive loosening in two decades. Since the beginning of this year the Federal Reserve has cut its federal funds rate nine times, from 6.5% to 2.5%. The first seven moves were the central bank's attempts to kick start the slowing economy. The last two were emergency measures in response to the terrors' attacks. It usually takes six months to a year to see the effects of the Federal Reserve's actions. Thus, the first impacts of the initial Federal Reserve loosening are only now being felt. The Federal Reserve also has more leeway in setting policy. In some past recessions Federal Reserve loosening was hamstrung by high inflation. Given the current low-inflation environment, the nation's central bank has more room to loosen further without over stimulating the economy. Lower interest rates should provide a welcomed boost to the current lackluster business investment climate.

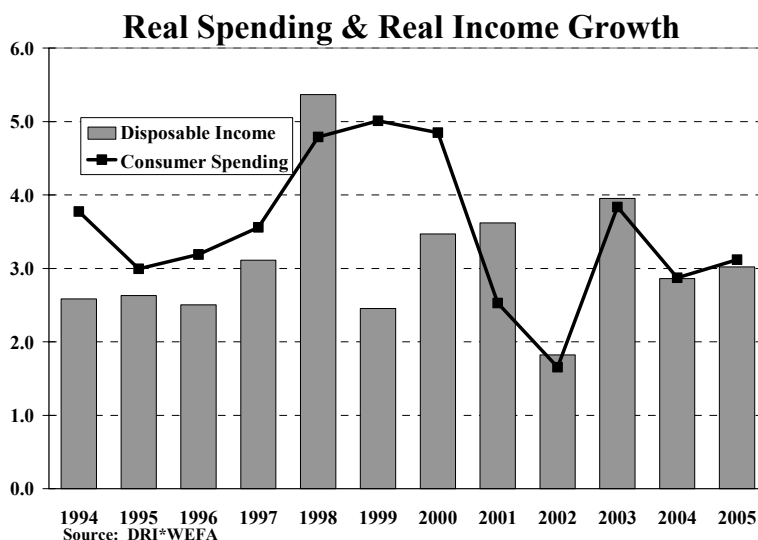
It was hoped that this summer's individual income tax rebate would be another factor that would kick start the faltering economy. Unfortunately, it appears this stimulant has not fulfilled its anticipated impact. Instead of spending most of the rebate, anecdotal evidence suggest Americans are banking a large portion of this windfall or using it to pay down their debts. Interestingly, this has not dampened all consumer spending. Sales of large-ticket items, most notably automobiles, have held up well this summer. Policymakers are considering a second round of fiscal relief to keep spending moving ahead after the terrorists' attacks. The ultimate direction and speed of spending may be determined by psychological instead of fiscal factors. The attacks could create a bunker mentality among consumers and cause them to hunker down. Alternatively, consumers could heed our leaders' patriotic appeals to keep the economy moving by spending.

As was already mentioned, the recession should be mild. In fact, it should be over by year's end. After slowing to a 1.1% pace in 2001, real GDP should expand 1.6% in 2002, 4.0% in 2003, 2.8% in 2004, and 3.2% in 2005.

SELECTED NATIONAL ECONOMIC INDICATORS

Consumer Spending: The hope that optimistic consumers would keep the economy out of a recession was dashed with the September 11, 2001 terrorists' attacks on America. Even before the attack there were signs consumer spending was faltering. Real consumer spending in the second quarter of this year was well below the previous year's pace. Other evidence also supports the case that consumers are hunkering down. For example, personal income rose 0.5% in July, yet consumption rose just 0.1%. After rising

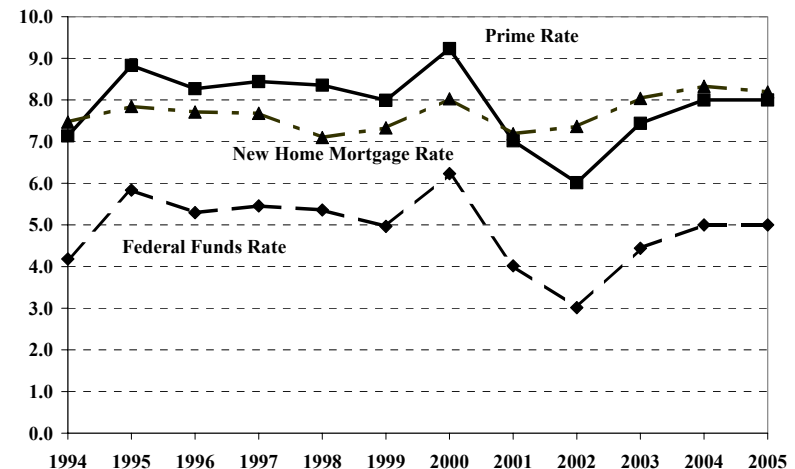
steadily to over 21.5%, the ratio of nonmortgage debt to disposable income is headed down. The personal saving rate rose to 2.5%, its highest level in over a year. All of these factors are consistent with consumers' anxieties about their employment situation and the lackluster stock market. Other factors suggest there is cause for these fears. Some spending was financed by expectations of continued overtime availability and income from second jobs. By the first quarter of 2001, debt service was claiming over 14.0% of disposable income—a share that tied the 1986 record. But the ongoing recession in manufacturing and the increasing number of pink slips have made it harder to make these debt payments. Indeed, the 25% increase in the number of nonbusiness bankruptcies in the second quarter suggests that the debt service burden may be getting unwieldy. (In fairness, some of the increase is due to marginal debtors claiming bankruptcy before tighter laws are imposed.) Not surprisingly, consumer confidence has declined steadily since last year. The University of Michigan's Index of Consumer Sentiment (1966:1=100.0) declined from 108.8 in the second quarter of 2000 to 91 in the second quarter of this year. This measure dropped 8 points in August 2001 alone. At that same time, two thirds of consumers viewed the economy as currently in decline and fewer than half expect an improvement in the next year. The University of Michigan reports its consumer sentiment index dropped to 81.8 in September 2001. Interestingly, most of this drop came before the September 11, 2001 terrorists' attacks. One need only look at recent history to find a parallel situation. In 1990, Iraq's invasion of Kuwait was the main reason consumer sentiment dropped nearly 25 points from the second quarter to the fourth quarter of that year, bottoming out at 65.1. It is anticipated consumer sentiment will drop from 91.0 in the second quarter of this year to a trough of 70.4 by year's end. As a result, real consumer spending is expected to retreat at a 2.1% annual rate during the last quarter of this year—its first reversal in a decade. Without the support of the consumer sector, the economy is forecast to experience a two-quarter recession over the second half of this year. This recession is expected to be milder than the 1990-91 recession. The forecasted recession lasts two quarters and real GDP declines 0.5% from peak to trough. In comparison, the 1990-91 recession lasted three quarters and real output declined 1.5%. There are a couple of reasons to believe the current recession should be milder than the previous one. First, low interest rates remain a lure for continued spending, especially for big-ticket items. Interestingly, some automobile manufacturers are even offering zero percent financing loan programs under certain circumstances. Second, consumers' household income has been boosted by \$40 billion in tax rebates. While it is not expected that all the \$40 billion will be spent, a portion of it will help cushion the impact of falling confidence. Consumers have the means and opportunity to spend. The biggest uncertainty is whether they have the will.



Financial: The nation's central bank finds itself with more latitude than usual to deal with current economic conditions. The Federal Reserve usually finds itself balanced on the razor's edge of promoting economic growth while keeping inflation in check. In addition, budget deficits in the past limited fiscal policy choices, putting even more pressure on monetary policy. This was indeed the case during the 1990-91 recession. Despite signs as early as 1989 the economy was slowing, the Federal Reserve eased gradually because inflation was high. Specifically, in 1989 consumer prices rose 4.8%, and

by about 7.0% in most of 1990. Fearful of fanning already hot inflationary fires, the nation's central bank's bellwether federal funds rate declined from about 8.2% from the recession's start to 6.5% at its end. The current low inflation situation has granted the Federal reserve more leeway to maneuver its policy. The Federal Reserve has cut interest rates aggressively since the beginning of this year in order to keep the economy moving forward. It was also able to make an emergency 50-basis point cut before the stock market reopened on September 17, 2001 in an attempt to ease financial market worries about liquidity. Since the beginning of this year, the Federal Reserve funds rate has dropped from 6.5% to 2.5%. And further cuts are still possible. One of the reasons the federal open market committee can afford to cut interest rates so aggressively is inflation has been relatively mild. In 2000, consumer prices increased just 3.4% despite huge jumps in energy prices. Even after cutting rates, consumer inflation slowed down this year as energy prices retreated. Once the central bank is confident the economy is on the mend it will refocus its attention on keeping inflation under control. To do this it will return to Chairman Greenspan's preferred approach of raising rates gradually beginning in the second half of 2002.

Selected Interest Rates

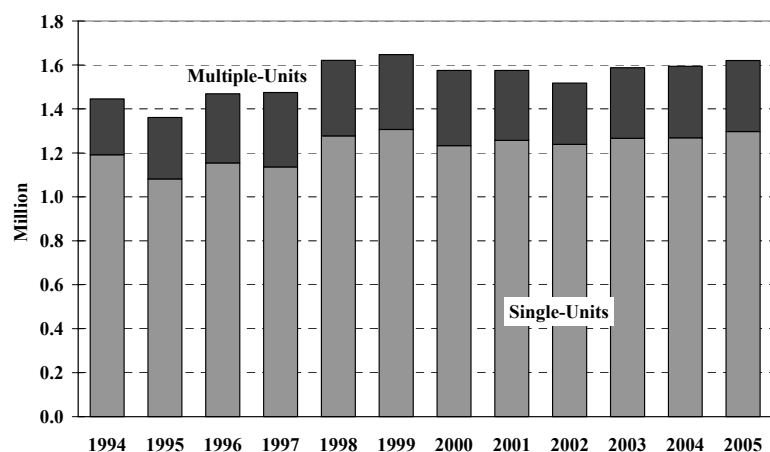


Source: DRI*WEFA

Housing: The outlook for the U.S. housing market has improved slightly despite recent and expected further declines in consumer confidence. In the July 2001 *Idaho Economic Forecast* it was anticipated that national housing starts would slide from 1.58 million units in 2000 to a trough of 1.51 million units in 2002. After 2002, it would grow gradually to 1.58 million units in 2005. In the current forecast, which includes the fallout from the terrorists' attacks, U.S. housing starts hold steady at 1.56 million units this year and bottoms out at 1.52 million units in 2002. Thus, the decline is slightly less severe than

previously thought. In addition, the recovery is stronger. Specifically, national housing starts climb to 1.62 million units in 2005. Likewise, the outlooks for sales of both new and used homes have been revised upwards in this forecast. The main reason for the improved outlook is the expectation of lower

U.S. Housing Starts



Source: DRI*WEFA

mortgage interest rates. It was previously believed the fixed mortgage interest rate would average 7.5% this year, 7.7% next year, 7.7% in 2003, and 7.8% in 2004. It is now expected to be more accommodating to the housing sector. In the current forecast, the mortgage interest rate averages 7.2% this year, 7.4% next year, 8.0% in 2003, and 8.3% in 2004, and 8.2% 2005.

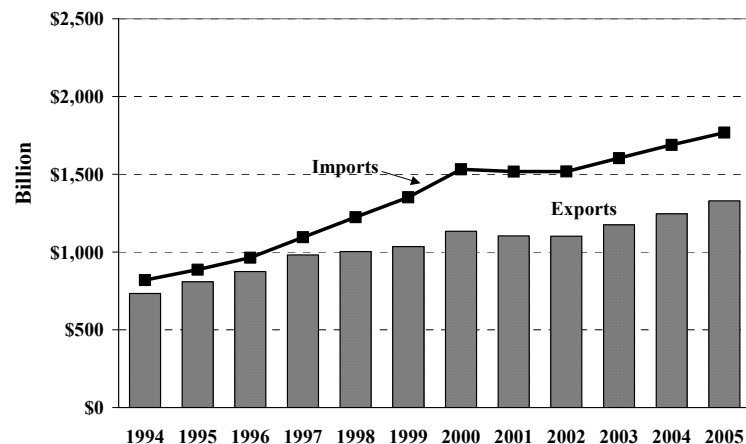
International: The U.S. recession should prove to be highly contagious. Even before the terrorists' attack, many countries were already teetering on the cusp of a recession. In many cases, trade with the U.S. was the only lifeline keeping them from a downturn. With the U.S. now expected to enter a short recession, it appears that foreign countries will get less of a boost from exports into this country and, thus, will face their own economic hard times. Japan's economy was expected to remain in the doldrums over the forecast period. However, hard times are not limited to the world's second largest

economy. Singapore is already in a recession and Taiwan is on the brink of a downturn. Most of the Asian economies were already hard hit by the triple whammy of a collapse in U.S. high-tech imports, a weaker yen (many Asian companies compete with Japan), and higher energy prices. Mexico is the country most likely to suffer from the U.S. recession because it is highly dependent on selling goods and services to the U.S. Other countries in Latin America are threatened by the looming devaluation or default in Argentina. Argentina is already in its third year of recession. Canada could also be pulled down by the U.S. slump because trade with the U.S. is a major part of its economy. Specifically, Canadian exports to the U.S. account for about 35% of that country's GDP.

Inflation: The combination of soft energy prices, tough foreign competition, weak business investment, and higher unemployment should keep a lid on both producer and consumer prices in the near future. The late summer run up in gasoline prices is not a sign of things to come because it was the result of special factors. Specifically, gasoline inventories were short last summer because declining margins caused refiners to initiate maintenance shutdowns or change products in anticipation of winter demand. Gasoline prices are expected to ease from last summer's

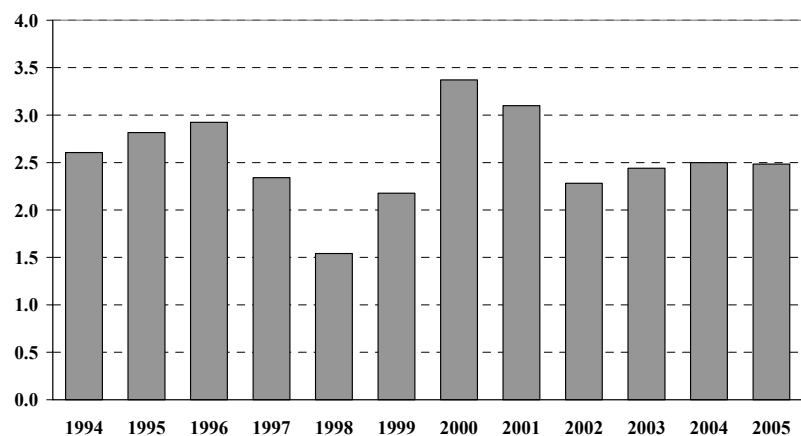
high. Balanced against temporary problems in petroleum markets are natural gas and electricity prices. A relatively cool summer has spared parts of the country from rolling blackouts. This good fortune has filtered back into natural gas markets where prices have drifted down all summer. And while electricity prices are still incorporating cost increases from earlier in the year, the supply/demand balances look

U.S. Imports and Exports



Source: DRI*WEFA

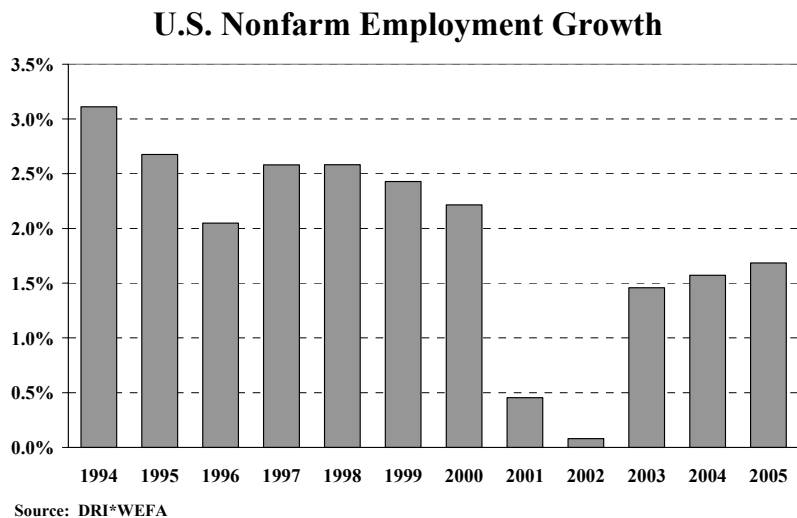
Consumer Price Inflation



Source: DRI*WEFA

much better going forward than they did late last year. This will help keep energy prices in check. As a result, the energy portion of consumer inflation is expected to decline through 2003. Core consumer inflation (all items less food and energy) is also forecast to be relatively tame. This is because core consumer inflation is driven primarily by employee compensation. It is anticipated that rising unemployment will ease pressures to raise employee wages and benefits. The current forecast shows the employee compensation index slowing to a 3.1% annual rate by the end of this year, which is less than half its 5.7% rate in 2000. The employee compensation index is forecast to rise just 2.9% in 2002, 2.7% in 2003, and 3.2% in 2004. The manufacturing recession will also limit core inflation. There is currently a worldwide glut of manufacturing capacity for a wide range of products. Those manufacturers who try to raise prices will find face resistance by consumers. Consumer prices are expected to rise 3.1% in 2001, 2.3% in 2002, 2.4% in 2003, and 2.5% in 2004.

Employment: The softening labor market finally showed up in the unemployment statistics this summer. The U.S. unemployment rate jumped to 4.9% in August 2001. The unemployment rate was significantly lower in the previous months despite other evidence that the labor market was slackening. Since the beginning of this year several major corporations have announced layoffs. The nonfarm job count also showed signs of weakness. The growth of nonfarm jobs has slowed significantly beginning with the second half of last



year. While the unemployment rate did rise initially, it seemed to hover too near 4.5% given the slowdown in job creation. Another sign that the employment picture was softening can be seen in the employee cost data. It would be reasonable to assume that wage and benefit pressures would ease when the labor market began to loosen. This is exactly what has been happening recently. At the end of last year the employee compensation index was rising at a 3.5% annual rate and a 4.6% rate in the first quarter of this year. It eased to a 4.0% annual rate in the second quarter of 2001 and is estimated to have slowed to a 3.8% pace in the third quarter of that year. This is consistent with a loosening labor market. However, the unemployment rate did not reflect this until late summer. Unfortunately, the labor market is forecast to turn further south over the next few quarters. Since the September terrorists' attack several large corporations, such as Boeing, have announced major layoffs. These losses will eventually show up in the official employment numbers. National nonfarm employment is expected to come to a virtual halt over the next two years before posting a gradual recovery. Specifically, the number of nonfarm jobs grows by 0.5% in 2001, 0.1% in 2002, 1.5% in 2003, 1.6% in 2004, and 1.7% in 2005. Over this same period the unemployment rate is expected to rise to from 4.0% in 2000 to 5.1% in 2005.

Business Investment: Real business investment, which had been an important engine of economic growth in the 1990s, turned into an anchor in the new millennium. A quick review shows how drastically things have changed. Real business fixed investment grew at a 10.6% average annual rate from 1995 to 2000. This was more than twice as fast as real GDP's 4.1% pace over the same period. Beginning in 2001, real business fixed investment began sliding. It declined slowly at first (a 2.1% annual rate in the first quarter), then it accelerated (an estimated 15% annual rate in the second quarter), and it is expected to weaken through the rest of the year. The important point here is that real business spending was already weakening before the September 11, 2001 terrorists' actions. It is too early to

quantify the economic impact of that terrible day. The net effects, though, will be negative. An event such as this strikes both the supply and demand sides of the economy. On the supply side, the economic effects resemble those of a natural disaster. Several billion dollars worth of the U.S. economy's productive capacity is gone. For example, the amount of office space lost in the World Trade Center bombing was the equivalent to that of a mid-sized city. However, given the nation has about \$30 trillion in capital stock, the supply-side effects will be small. The demand-side effects

will be complex. On the one hand, business spending will rise to reconstruct what was lost in the bombings. Spending will also increase for military and security purposes. This will be further assisted by an infusion of tax reductions. On the other hand, the disaster is likely to depress business sentiment. Before the terrorists' attacks, real business fixed investment was forecast to decline 2.7% this year, fall 1.0% next year, rise 6.8% in 2003, 5.7% in 2004, and 5.2% in 2005. Taking into account the effects of the bombings, the current outlook is for real business fixed investment to decline 3.2% in 2001, drop 2.8% in 2002, increase 7.5% in 2003, rise 6.7% in 2004, and grow 5.6% in 2005.

